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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1124

SOUTHWESTERN LIFE INSURANCE COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Southwestern Life Insurance Company, the Petitioner herein, petitions for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit which reversed, in part, and remanded the judgment of the United States District Court for the Northern District of Texas.

OPINIONS BELOW

This case originally involved several issues, only one of which Petitioner seeks review. The opinions of the courts

below are printed in a separate Appendix volume. The full decision of the Fifth Circuit is reported at 560 F.2d 627 (1977). It is reprinted in the Appendix (App. pp. A-1 to A-53). The decision of the Fifth Circuit relating to the issue here involved is reported at 560 F.2d 637 to 639 (App. pp. A-25 to A-31). The full opinion of the United States District Court for the Northern District of Texas is not officially reported. It is reported at 75-1 CCH U.S.T.C. ¶9321 (1975), and is reprinted in the Appendix (App. pp. B-1 to B-54). That portion of the District Court's opinion that relates to the issue here presented is reprinted in the Appendix (App. pp. B-19-22; 43-44). The Order of the Fifth Circuit denying Petitioner's petition for rehearing is set forth in the Appendix (App. p. C-1).

JURISDICTION

The decision of the Fifth Circuit was entered on October 5, 1977. A Petition for Rehearing was timely filed by Southwestern Life Insurance Company, which Petition was denied on December 2, 1977.

The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Section 804 of the Internal Revenue Code of 1954, as amended,[1] excludes from a life insurance company's taxable investment income that portion of such investment income which is attributable to and held for the purpose of meeting the policy and other contract requirements of the company. The investment income held for the policyholders of a life insurance company is, in general, determined by multiplying

[1] Hereinafter referred to as the "Code".

each item of investment income by a fraction, the numerator of which is the contract liability requirements of the policyholders and the denominator of which is the total net investment income. Section 805 of the Code defines the numerator of this fraction, *i.e.*, policy and other contract liability requirements, to include, *inter alia*, "interest paid". Further defining "interest paid", Section 805(e)(2) provides that "interest paid" shall include ". . . amounts in the nature of interest whether or not guaranteed, for the taxable year on insurance or annuity contracts. . . which do not involve, at the time of accrual, life, health, or accident contingencies."

The primary question is whether the District Court was correct in holding that amounts paid or credited by Petitioner as "excess interest" with respect to pension funds which it administers constitute "amounts in the nature of interest" and, therefore, are to be excluded from Petitioner's taxable investment income; or whether, as the Court of Appeals held, the pension contracts involve "life, health, or accident contingencies," and, therefore, the "excess interest" is to be included in Petitioner's taxable investment income, notwithstanding these amounts are, in fact, paid or credited to third party pension funds.

2. In the alternative, the question is whether the pension fund contracts which Petitioner administers in fact involve life, health, or accident contingencies at the time the excess interest is accrued. The District Court made no findings of fact or conclusions of law with respect to this question in view of its interpretation of Section 805(e)(2). The Court of Appeals did not address itself to this question.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.) Section 805(e):

> (e) INTEREST PAID. — For purposes of this part, the interest paid for any taxable year is the sum of —

(1) INTEREST ON INDEBTEDNESS. — All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

(2) AMOUNTS IN THE NATURE OF INTEREST. — All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.

(3) DISCOUNT ON PREPAID PREMIUMS. — All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

(4) INTEREST ON CERTAIN SPECIAL CONTINGENCY RESERVES. — Interest for the taxable year on special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.: Section 1.805-8. Interest Paid):

(a) *In general.* Section 805(e) provides four categories of interest items the sum of which constitutes the "interest paid" for any taxable year. Interest paid is

one of the elements of the policy and other contract liability requirements of a life insurance company. The amount of the policy and other contract liability requirements is used in determining the policyholders' share of each and every item of investment yield which is not included in taxable investment income. See section 804(a) and §1.804-2. Interest paid includes interest on indebtedness, discounts on prepaid premiums, and interest on insurance or annuity contracts for which no provision is made in the life insurance reserves. Interest paid does not include dividends to policyholders (as defined in section 811(a) and paragraph (a) of §1.811-2) or amounts derived from mortality savings or expense savings. In computing the interest paid for any taxable year the same item may not be included more than once.

(b) *Interest paid defined.* For purposes of part I, subchapter L, Chapter 1 of the Code, the term "interest paid" as used in section 805(e) means the sum of —

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(2) All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve at the time of accrual, life, health, or accident contingencies. Amounts in the nature of interest do not include amounts derived from or representing mortality gains, expense savings, underwriting profits, or other items not in the nature of interest. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest accrued within the taxable year on such contracts. A contract to pay insurance benefits in

installments over a specified period, for example, a contract to pay the insurance benefit in 10 annual installments, is considered as a supplementary contract not involving life contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by either the insured or a beneficiary after the policy matured. Thus, no distinction is made based on the person choosing the method of payment, and the full amount of the interest accrued, and not merely the guaranteed interest, is considered as interest paid. Amounts in the nature of interest include interest on dividends left on deposit with the company and interest on premiums paid in advance.

STATEMENT

Petitioner is a life insurance company organized in 1903 under the laws of the State of Texas, with its principal place of business in Dallas, Texas. As such, it is under the control and supervision of the State Board of Insurance of Texas. Petitioner, for each year 1958 through 1965, timely filed its Federal income tax return on Form 1120L and paid the amount of tax liability shown to be due. (App. pp. B-1, B-2.) Petitioner is engaged in issuing multiple forms of life and accident insurance, including individual and group life insurance policies, individual and group annuity contracts, individual and group accident and health contracts, term life insurance contracts, and annuity and life insurance contracts designed specifically for qualified pension and profit sharing plans (within the meaning of Section 401(a) of the Code).

Based on 1976 data, Petitioner was the twelfth largest stock life insurance company by total assets in the United States and was the second largest in the State of Texas.

During the years in question, 1958 through 1965, Petitioner issued four basic forms of insurance contracts to qualified pension plans: (a) pension trust annuity contracts, (b) group permanent annuity contracts, (c) pension trust life contracts, and (d) group permanent life contracts.[2] Under the laws of the State of Texas, Petitioner could not guarantee more than 3.5 percent interest on pension plan reserves. (App. pp. B-20, B-22.) Therefore, in order to be competitive with bank trust departments and other savings institutions for private pension plan funds, Petitioner agreed to pay its pension plan customers amounts in excess of the interest rates which could be guaranteed in the reserves pursuant to Texas law. Since interest rates on current investments ordinarily were and still are in excess of the 3.5 percent, Petitioner agreed to pay such pension trust funds "excess interest" in accordance with its fixed predetermined formula. This formula, generally termed the "new money rate" formula, operates in the following manner:

(a) Petitioner measures the investment income in terms of a percentage rate of return on new funds

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[2] The difference between the pension trust annuity contracts and the group permanent annuity contracts which Petitioner issues is primarily one of mechanics. They both provide the same premium rate in relationship to benefits, although the group permanent annuity contracts have a smaller aggregate premium solely by the expense saving in issuing only one master group policy. Similarly, the same distinction exists between the pension trust life contracts and the group permanent life contracts. The basic difference between the annuity and life contracts is that the latter provides a death benefit greater than the cash value from the date of issue to the date when reserves equal or exceed the death benefit. This equalization normally occurs at approximately age 58.

invested by it during a current year. This percentage rate is referred to as the new money interest factor.

(b) Petitioner reduces the new money interest factor by 1/2 of 1% as a management fee.

(c) The new money interest factor (after reduction for management fee) is then reduced by the amount of guaranteed interest in the policy to arrive at the excess interest rate, which is then multiplied by the current mean reserves of the policies still in force; this is the amount of excess interest.

(d) From the amount of excess interest, there is subtracted $100 plus 5¢ for each policy in force as a calculation fee; the net amount constitutes the amount which is actually paid or credited by Petitioner on the pension plans which it administers.[3]

The base of Petitioner's excess interest formula is derived solely from its investment earnings, and the formula does not involve or consider any elements of mortality gain, expense savings or underwriting profits. (App. p. B-22.)

On all of the pension contracts upon which excess interest is paid, Petitioner establishes an initial premium at date of issue. The rate is predetermined and precalculated. Generally, this premium guarantees that at age 65, the plan participant will have an annuity which will provide him a specified amount per month for life (or other optional monthly benefits). In addition, at retirement, the Petitioner contractually offers the participant the annuity guaranteed

[3] The net result of this formula is expressed in terms of dollars. However, it will hereinafter be expressed as a percent and termed the "adjusted new money rate".

from the date of issue of the contract or the right to purchase another annuity which could then be purchased with the cash value, whichever will produce the higher monthly benefit. At retirement age, normally 65, there is a life contingency in the event that the pension plan participant elects to take his benefits other than in a lump sum, *i.e.*, an annuity benefit payable for life only, ten years certain and life, or a joint and survivor annuity. During the accumulation period on the *annuity* contracts from date of issue to retirement date, the death benefit is equal or equivalent to the surrender value of the contract. The surrender value of the contract in turn is equal to the reserves.[4] With respect to the pension trust annuity contracts and the group permanent annuity contracts, there is no life contingency from the date of issue through the retirement date. The only life or mortality contingency involved is that, when the participant reaches age 65 or retirement age, such participant may elect a life annuity involving a mortality risk, instead of the surrender benefit. The initial premium calculation assumes that such contingency will occur.

During the accumulation period of the pension trust *life* contracts and the group permanent *life* contracts, a death benefit would be paid over and above the surrender value of the annuity contract only in the event the participant died before the reserve equaled or exceeded the death benefit. Ordinarily, this "cross-over" point would occur approximately seven to eight years before retirement age or age 65.

[4] This will not be true for approximately the first two years because of the "loading" factor, primarily attributable to agents' commissions. However, the NAIC and the State Insurance Departments do not describe this small disparity as a "life contingency". Neither, apparently, does the Government.

An example[5] may simplify and more sharply focus upon the issue in this case. Assume the following:

Mean Pension Plan Reserves	$1,000,000.00
Guaranteed or "Maximum Legal" Interest Rate	3.5%
Current Earnings Rate on Total Investments of the Company	4.0%
Credited to Pension Plan Funds (Adjusted New Money Rate).....	5.5%
Gross New Money Rate	6.5%

Applying the above assumptions to Petitioner's question here involved, Petitioner issues pension fund contracts under which it guarantees a rate of 3.5 percent. The gross new money rate under the above-described formula is 6.5 percent, and the adjusted new money rate is 5.5 percent. The "excess interest" would be the difference between the guaranteed rate of 3.5% and the adjusted new money rate of 5.5%, or an additional 2% of the mean reserves, which is $20,000.00.

For Federal income tax purposes, Petitioner, in computing the amount of exclusion of investment income attributable to policyholders, properly used the current earnings rate (4% in the above example) times the mean pension plan reserves, (Section 805(a)(2) of the Code.) In addition, it excluded the "excess interest" of 2% in the above example as "amounts in the nature of interest" within the meaning of Section 805(e)(2). Upon examination, the Internal Revenue Service disallowed as an element in the exclusion numerator for policy and other contract requirements the "excess interest" (2%). It did not disallow, and there is no controversy with

[5] In the interest of simplicity, Petitioner will use this example throughout this Petition. This example accurately develops the issue involved in this case.

respect to Petitioner's entitlement to utilize, the current earnings rate (4%) in determining the net investment income attributable to the policyholders as the "current earnings rate" on pension plan reserves in accordance with Section 805(a)(2) of the Code. For Federal income tax purposes, the guaranteed maximum legal rate of 3.5% insofar as pension plan earnings are concerned has no independent significance.

The District Court held that the amounts paid or credited by Petitioner as excess interest (2%) to its pension plans constitute "amounts in the nature of interest" within the meaning of Section 805(e)(2) of the Code, thereby excluding such amount from Petitioner's taxable investment income. (App. p. B-44.) In effect, the District Court held that it was simply not Petitioner's "income" but "income" that belonged to the pension trust. The Court of Appeals reversed, holding, in substance, that for the "excess interest" to be excludable as "amounts in the nature of interest", it must be paid or credited on contracts which do not involve life, health or accident contingencies. (App. p. A-31.) Neither the Court of Appeals nor the District Court addressed themselves to the facts underlying the question of whether, *at the time of accrual* of the excess interest, the pension contracts involved, life, health, or accident contingencies. The total amount of the excess interest paid by Petitioner in the years 1958 through 1965 and which the Internal Revenue Service disallowed as an exclusion from Petitioner's income as amounts in the nature of interest was $3,477,871.90. More than 65% of the excess interest amounts was credited to these pension plans at a time when, under Petitioner's view, the annuity or life contracts did not involve life, health or accident contingencies.

All reserve requirements for the annuity contracts and life contracts are computed at the time the policies are issued,

and the reserves for these contracts at the time they are computed involve life, health and accident contingencies. The District Court in this case so found (see App. p. B-44), and the Court of Appeals did not dispute this finding. In the broad sense, the Court of Appeals, however, held that the "excess interest" paid by Petitioner was the income of Petitioner and not that of the policyholders, even though Petitioner had paid or credited such amount of "excess interest" to its policyholders.

REASONS FOR GRANTING THE WRIT

1. The question of "whose income is it" is at the very heart of this issue. If the "excess interest" is the policyholders' income, it should not be subject to taxation to Petitioner. Under the taxing formula developed by Congress in The Life Insurance Company Income Tax Act of 1959,[6] there is a fundamental premise that income attributable to or set aside for policyholders is the policyholders' income and should not, therefore, be taxed to the life insurance company. One item of income that is attributable to policyholders under the statute is "amounts in the nature of interest" as set forth in Section 805(e)(2) of the Code.

This Court recently considered a corollary question under the 1959 Act of "whose reserves are they." *United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 97 S.Ct. 430 (1977). The specific question there involved an interpretation of Section 801 in determining whether an insurance company qualified as a "life" insurance company for Federal income tax purposes. In turn, the answer to the qualification question depended upon whether the reserves were

[6] P.L. 86-69, 73 Stat. 112. Although titled the "Life Insurance Company Income Tax Act of 1959", the first year that the Act was effective was 1958, not 1959. References to such Act will be termed the "1959 Act".

attributable to the reinsurer or the reinsured, *i.e.*, "whose reserves are they." Although this Court in that case was presented with a different technical issue than the issue here involved, the fundamental policy question is the same.

The premise that a tax should not be levied on the net investment income that is attributable to meet obligations to policyholders with respect to a life insurance company was first contained in the Revenue Act of 1921. It was carried forward in subsequent acts dealing with life insurance company taxation, although various formulae were used in computing the amount of the reserve deduction which is attributable to policyholders of a life insurance company.[7] In connection with the 1959 Act, the House, in its version, continued this concept of a *deduction* from a life insurance company's investment income to meet policyholder requirements. However, the Senate developed the expanded concept that the life insurance company and its policyholders were basically two partners who shared items of investment income and expense. The share or amount belonging to the policyholders is to be *excluded* from the company's tax base and, therefore, not subject to tax. The House receded in conference and Congress, in the 1959 Act, adopted the *exclusion* concept.[8]

[7] Revenue Act of 1921, c. 136, Sections 242-247, 42 Stat. 261-264; Revenue Act of 1924, c. 234, Section 245(a), 43 Stat. 289-290; Revenue Act of 1926, c. 27, Section 245(a), 44 Stat. 47-48; Revenue Act of 1928, c. 852, Section 203(a), 45 Stat. 842-844; Revenue Act of 1932, c. 209, Section 203(a), 47 Stat. 224-225; Revenue Act of 1936, c. 690, Section 203(a), 49 Stat. 1710-1711; Revenue Act of 1938, c. 289, Section 203(a), 52 Stat. 523-524; Internal Revenue Code of 1939, Section 203(a), 26 U.S.C. (1952) ed.) 203(a).

[8] This Court, in *United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 85 S.Ct. 1379 (1965), stated:

> "Under the 1959 Act the undivided part of a life insurance company's assets represented by its reserves is considered as a fund held for the benefit of the policyholders." 381 U.S. at 239.

Therefore, in approaching a proper statutory interpretation of Section 805(e)(2), the fundamental question of "whose income is it" must precede analysis of the grammatical construction contained in such section.[9] With respect to the "excess interest" paid or credited by Petitioner to its policyholders, the Court of Appeals held, in effect, that even though these amounts legally belonged to the policyholders, they were nevertheless taxable to Petitioner. This answer is in direct contradiction to the underlying thesis of the 1959 Act. The "excess interest" was paid or credited to the policyholders. Therefore, assuming that more than one interpretation of Section 805(e)(2) can be made, the interpretation should be made that accords with the fundamental policy of Congress. This question is of sufficient importance to merit this Court's consideration and ruling on the clear underlying Congressional intent and the apparent contradictory result of the Court of Appeals.

2. Using the example set forth on p. 10, *supra*, if a bank held pension plan reserves of $1,000,000 and credited an adjusted new money rate of 5.5% ($55,000) on these reserves, the bank would get a deduction (exclusion) of $55,000 in

[9]This Court has considered the fundamental concept of "whose income is it" in various contexts. For example, an oil and gas royalty owner's share of production is *excluded* from the working interest owner's share of production, even though they both have an economic interest in the same reservoir. See *Anderson v. Helvering*, 310 U.S. 404, 60 S.Ct. 952 (1940). A person who attempts to assign income to another is still taxable on it. *Helvering v. Horst*, 311 U.S. 112, 61 S.Ct. 144 (1940). Insurance income is properly realized by a related life insurance company, not by a bank which controlled the insurance company. *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394, 92 S.Ct. 1085 (1972). Contributions to a retirement plan by a health plan foundation were currently taxed to the partnership that provided the services. *United States v. Bayse*, 410 U.S. 441, 93 S.Ct. 1080 (1973).

computing its tax liability; hence, it would owe no tax with respect to the pension funds it administers. On the other hand, if a life insurance company (Petitioner) held the same reserves and credited the same adjusted new money rate on these reserves, under the Court of Appeals decision it would only be entitled to exclude 4% or $40,000 based on its current earnings rate. That would leave $15,000 on which the life insurance company would be taxable even though it, like the bank, paid or credited the entire $55,000 to the pension plan. Assuming a 48% corporate tax rate, the life insurance company would pay tax of $7,200 versus the bank's zero on the same amount paid or credited to the pension plans.

While it is impossible to determine the total impact of this disparity of treatment on the life insurance industry, it is estimated that the amount of private pension reserves held by all United States life insurance companies was approximately $88,400,000,000 as of December 31, 1976. Of this total amount of reserves, it is estimated that $30,000,000,000 could relate to "active life" pension reserves which could involve excess interest.[10] By relating the $15,000 of additional income, upon which the life insurance company would be taxed in the above example as compared to a bank, and the $1,000,000 of pension plan reserves used in that example to the $30,000,000,000 of pension plan reserves (1.5%), the result of upholding the decision of the Court of Appeals is estimated to have an adverse economic impact (giving effect to Federal income taxes at a corporate rate of 48%) of .72% of those private pension reserves held by life insurance companies. This translates into an additional

[10]Statistics published by the American Council of Life Insurance for 1976 indicate private pension plan reserves totalled $88,400,000,000. *Life Insurance Fact Book '77*, p. 40. This amount is then reduced for separate account reserves and policies which do not appear to generate excess interest.

annual tax charge to the life insurance industry over other financial institutions which handle such pension funds that could exceed $200,000,000.

Notwithstanding the fiscal importance to the Treasury of this amount, of overriding importance is the expressed Congressional intent to aid small businesses to establish exempt qualified pension plans. The Senate Finance Committee Report[11] clearly states this policy:

> "In determining the share of the investment income to be attributed to the policyholders and, therefore, not subject to taxation with respect to the life insurance company, one element taken into account under both your Committee's Bill and in the Bill as passed by the House is the investment income earned in connection with reserves accumulated for qualified employer pension and profit sharing plans. In determining this element, which is not to be taken into account in determining the tax base of a life insurance company, both versions of the Bill provide that an amount is to be attributed to the policyholders equal to the current earnings of the company on its book reserves held for qualified pension and profit sharing plans. To the extent that the insurance company holds additional amounts of surplus to cover its contingencies under these qualified plans, the investment income on the surplus will be subject to tax at corporate rates in the hands of the company. This will also be true to the extent that such income enters into the underwriting income tax base and is not paid out in the form of policyholder dividends. Likewise, a tax will still be imposed at the company level to the extent of any capital gain tax attributable to this income.

[11] Sen. Fin. Comm. Rep. No. 291, 86th Cong., First Sess., pp. 7-8.

> This favorable treatment for qualified pension and profit sharing business is believed desirable in view of the fact that investment earnings of a qualified pension or profit sharing trust are completely exempt from tax while they are accumulated in the trust. Generally speaking, it is the smaller employers who are forced to set up insured pension plans rather than trusteed pension plans because of the greater risk and higher ratio of expense connected with the operation of a small trust. A higher tax on similar earnings in the hands of insurance companies than is provided in the case of trusteed plans therefore is generally discriminatory against small businesses. This accounts for the treatment provided by both the House Bill and your Committee's Bill . . . ."

This $200,000,000 detriment to insurance companies as contrasted with other financial institutions is contrary to what Congress intended in attempting to create a competitive climate between banks and insurance companies for the private pension plans of small businesses.

On this basis, the industry will be forced either to stop writing such "excess interest" business because it generates an economic loss, or reduce the amount of "excess interest" it will pay to take into account the adverse tax effect. The end result is, or course, that small businesses will suffer because their choice will be to set up either more expensive non-insurance company trusteed plans or accept a lower return from insurance companies, a result completely divergent from what Congress intended in enacting the 1959 Act.

In view of the potential and substantial economic loss to the life insurance industry and in view of the certain

litigation to be spawned by this issue,[12] this Court should hear and resolve this question and establish a national solution for the benefit of not only the life insurance industry and the Government alike, but also for many small businesses which place pension funds with life insurance companies and are entitled to expect the best rate of return on their invested premiums.

3. The Court of Appeals seemed greatly influenced by the assertion that to sustain Petitioner's interpretation would:

> "... in effect, give a double benefit to the taxpayer because the excess earnings on its reserves, as we have already pointed out, have already been included in the numerator of the fraction because *all* of the company's earnings on reserves, including the excess over the 3½% rate, have been included in the term 'the adjusted life insurance reserves'." (App. p. A-28.)

This statement is not correct. The only interest rate which has been included in computing the Petitioner's "adjusted life insurance reserves", *i.e.*, pension plan reserves, is the current earnings rate as provided by Section 805(a)(2) (4% in the example). Therefore, if Petitioner's view is sustained, only

[12] One can easily envision litigation reaching the proportion that the "deferred and uncollected" premium issue reached since 1958. This Court finally resolved that issue only last year in *Commissioner v. Standard Life & Accident Ins. Co.*, ... U.S. .... , 97 S.Ct. 2523 (1977). It is equally significant to observe that this Court has heard only three cases involving issues under the 1959 Act. *United States v. Atlas Life Ins. Co., supra; United States v. Consumer Life Ins. Co., supra* (three consolidated cases) and *Commissioner v. Standard Life & Accident Ins. Co., supra.* The life insurance industry, involving more than 1750 companies in the United States, has a substantial effect on the economy. Resolution of issues and certainty of questions of taxation are in the public interest.

the excess of the current earnings rate over the maximum statutory interest rate on reserves (.5% in the example), would be included in the numerator twice. Using the 1976 industry figures on p. 15, *supra*, this excess for the life insurance industry could approximate $72,000,000,[13] but this result is solely a function of the taxing formula provided in the 1959 Act. Moreover, if because of a declining economy, the current earnings rate falls below the guaranteed interest by the same amount as the current earnings rate exceeds the guaranteed rate (*i.e.*, .5%), the insurance industry would suffer an economic tax loss equal to $72,000,000. Thus, the insurance industry may benefit or may suffer from this provision. As stated in the Senate Finance Committee reports (*supra*, note 11 at 5):

> "Your committee concluded, after considering the matter very carefully, that it was not desirable to make use of the assumed rates, either the company's own individual rate or the industry average, in determining the policyholder's share of investment income."

Therefore, this Court should hear this case in order to correct the Court of Appeals in its assumption that to sustain Petitioner's position would result in a double tax benefit to the extent of *all* the excess interest. The fact is that Congress intended to apply the formula approach which goes further than state law allowances in the amount of investment income that is attributable to pension plan reserve earnings.

4. The 1959 Act (Sections 801-820 of the Code) provides a three phase procedure for the taxation of life insurance

[13] This amount is derived as follows: Current earnings rate (4%) — maximum statutory rate (3.5%) = .5% x 48% tax rate x 30,000,000,000 pension plan reserves = $72,000,000.

companies. The primary categories of income subject to tax are "taxable investment income" (as defined in Section 804), "gain from operations" (as defined in Section 809) and the "deferred portion" of underwriting income that is not taxed until such income is made available to shareholders. (Section 815) See *United States v. Atlas Life Ins. Co., supra,* Note 2.

The primary question in this case is whether the "excess interest" paid by Petitioner pursuant to its pension plan contracts is investment income attributable to the policyholders or whether, notwithstanding the fact that it is paid or credited to third party pension plans, it is part of the Company's taxable investment income. This question in turn depends upon the answer to whether these "excess interest" payments are "amounts in the nature of interest" within the meaning of Section 805(e)(2).

The determination of policyholder's share of investment income that is not taxed to the insurance company is generally determined by multiplying each item of investment yield (income) by a fraction, the numerator of which is "policy and other contract liability requirements" and the denominator of which is the total investment yield (income). Section 805 of the Code provides that the "policy and other contract requirements" means the sum of the following:

1. The adjusted life insurance reserves multiplied by the adjusted reserves rate,

2. The mean of the pension plan reserves at the beginning and end of the taxable year multiplied by the current earnings rate, and

3. The interest paid.

One component of "interest paid" is "amounts in the nature of interest" as set forth at p. 4, *supra*. The District Court found that Petitioner's payments as "excess interest" were "amounts in the nature of interest" within the meaning of Section 805(e)(2) and it is submitted that these findings are not clearly erroneous. The Government's regulations, quoted at pp. 4-6, *supra*, significantly provide that interest paid includes ". . . interest on insurance or annuity contracts for which no provision is made in the life insurance reserves. . . ." In the instant case, Petitioner, in its pension plan reserves (*i.e.*, life insurance reserves), only made provision for the maximum statutory interest (3½%). No amount of the "excess interest" which is at issue here is interest included in Petitioner's life insurance reserves. Moreover the *source* of the amounts credited to the pension plan reserves is not in dispute. These amounts arise solely from investments and do not involve mortality gains, expense savings or underwriting profits. Further, the above-quoted Regulations state that ". . . so-called excess-interest dividends. . ." are to be treated as amounts in the nature of interest within the meaning of Section 805(e)(2). Therefore, Petitioner submits that it has met all criteria in the statute and regulations and is entitled to exclude from its share of taxable investment income the "excess interest" payments here at issue.

The present Section 805(e)(2) was first enacted by Congress in the Revenue Act of 1942, as an amendment to the 1939 Code.[14] Section 201(c)(6)(B) of the Internal Revenue Code of 1939 provided a "deduction" for:

"All amounts in the nature of interest whether or not guaranteed, paid within the taxable year on insurance or

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[14] Revenue Act of 1942, 77th Cong., 2d Sess.

annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve at the time of payment, life, health or accident contingencies."

Further, Section 805(d)(2) of the 1954 Code, prior to the enactment of the 1959 Act, provided a "deduction" for:

"All amounts in the nature of interest whether or not guaranteed, paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve at the time of payment or accrual life, health, or accident contingencies"

The Senate Finance Committee Report under the 1959 Act states that Section 805(e)(2) is, in substance, the same as Section 805(d)(2) of the 1954 Code. And, Section 805(d)(2) of the 1954 Code is substantially identical to Section 201(c)(6)(B) of the 1939 Code. Moreover, in connection with the Tax Reform Act of 1969, the Senate Finance Committee stated:

"As indicated above, the amounts deducted (excluded from taxable income of a life insurance company) in this respect has included not only amounts added to what are called life insurance reserves, but also, among other items, interest paid on indebtedness and amounts in the nature of interest on insurance or annuity contracts which do not involve, at the time of accrual, life, health or accident contingencies. At the time this latter provision was added to the Code in 1942, the Congress in its committee reports indicated that (t)his provision was to be interpreted broadly. It said that the provision includes amounts in the nature of interest such as so-called excess interest dividends and guaranteed interest

but Congress did not restrict the provision to only these items. In 1959 when the tax treatment of life insurance companies was substantially revised and broadened, this provision was nevertheless carried over substantially unchanged from prior law and again Congress indicated that it was to be interpreted broadly."[15]

Broadly interpreted, it is submitted that the language used in the predecessor sections of Section 805(e)(2) demonstrates that the phrase "life, health or accident contingencies" referred to the amounts *paid, i.e.*, the *source* of the amounts. If the source of the amounts paid involved life contingencies, such amounts, however designated, were not treated as attributable to the policyholders' share of the income but were rather treated as taxable to the company; however, if the source was investment earnings, they are to be excluded from the company's taxable investment income. It is undisputed that the source of the "excess interest" amounts in this case involved no life contingencies but related solely to income from investments made by Petitioner.

This position is strengthened by Section 805(e)(3) which was first enacted in the 1959 Act. That provision treats as "interest paid" discounts given by life insurance companies on premiums paid in advance on life and annuity contracts. Discounts are really interest in reverse. If premiums are paid in advance, the company has use of the money between the payment date and the due date upon which it earns money. The amount of discount is ordinarily measured by two factors: (a) time, and (b) use of money, *i.e.*, interest. There is no question that under Section 805(e)(3) the insurance

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[15] Sen. Fin. Comm. Rep. No. 91-552, First Sess. 1969-3 C.B. 423,601.

contracts involve life, health and accident contingencies. Nonetheless, the discounts referred to are treated as "interest paid" and, therefore, deemed to be earned on behalf of the policyholders and not the insurance company. In fact, all three subparagraphs of Section 805(e) relate to situations where a life insurance company derives or is deemed to derive income (discounts) from investment activity and not mortality or other savings. Therefore, such payments or discounts are treated as policy and other contract liabilities which result in an exclusion from the life insurance company's taxable investment income.

The Court of Appeals in this case interprets Section 805(e)(2) to say even though the "excess interest" arises solely from investment earnings, if these amounts are accrued on *contracts* which do involve life, health or accident contingencies, no exclusion of the amounts is permitted, even though they are, in fact, accrued, credited or paid. Petitioner suggests that, in accordance with Congressional intent, Section 805(e)(2) should be broadly construed, *viz.*, if the amounts do not arise from mortality gains or expense savings but arise solely from investment income and the same amounts are not included in the computation of the pension plan or life insurance reserves, then they are "amounts in the nature of interest" attributable to policy and other contract liability requirements.

Therefore, it is submitted that the proper interpretation of Section 805(e)(2) with respect to Petitioner's "excess interest" payments is to provide an exclusion:

> ". . . for all amounts in the nature of interest . . . for the taxable year on insurance or annuity contracts which [*amounts*] do not involve at the time of accrual life, health or accident contingencies."

The United States Court of Appeals for the Fifth Circuit erred in interpreting the statute to the contrary.

5. Alternatively, Petitioner submits that in excess of 65% of the excess interest amounts was paid or credited to these pension plan contracts at a time when the annuity or life contracts did not involve life, health or accident contingencies. With respect to the *annuity* contracts, the death benefit is always equal to the surrender value of the contracts prior to retirement age or age 65.[16] In other words, during the accumulation period from the date of issue, in each year when the amounts of "excess interest" are accrued with respect to these annuity contracts, these contracts do not involve life contingencies since there is no "insurance risk" attributable to these contracts. Moreover, the evidence showed that the amounts payable on death under the *life* contracts from approximate age 58 to age 65 were not greater than the reserves maintained for these policies. Therefore, because Petitioner's obligation to the policyholder in the event of death is the same as the cash value, Petitioner had no life insurance amount at risk or life contingencies at the time of accrual of the excess interest past age 58.

The District Court made no findings with respect to the life contingency status of any of these contracts at the time excess interest was accrued from year to year. Such findings, of course, were not required in view of the District Court's holding that Petitioner was entitled to exclude the total amount of "excess interest" accrued with respect to both the annuity and life contracts.

Even granting the Court of Appeals' construction of Section 805(e)(2) that the modifier of the words "life, health

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[16] See note 4, *supra*.

and accident contingencies" is the word "contracts" and not the word "amounts", nowhere in the record is there a finding that during the accumulation period on the annuity contracts and past the age when the cash value equals the death benefit on the life contracts, these various contracts, at the time of accrual, involved life, health or accident contingencies.

Further, a finding that at the *time* of accrual of "excess interest" the majority of these contracts did *not* involve life, health or accident contingencies is not inconsistent with the District Court holding that, for reserve purposes, these contracts *did* involve life, health or accident contingencies. Section 801 deals with the *computation* of life insurance reserves and defines such reserves as ". . . amounts . . . which are set aside to . . . liquidate . . . claims arising from . . . annuity . . . contracts . . . involving *at the time with respect to which the reserve is computed*, life, health or accident contingencies."[17] (Emphasis added) The reserves are computed at the time the premium is computed; that is, the date of issue. On the other hand, Section 805(e)(2) relates to the time when the amounts in the nature of interest ("excess interest") are accrued, a different point in time than when the reserves are computed. These time periods serve two different functions and two different purposes. One, a purpose when the reserve is computed in order to determine under Section 801 whether they qualify as "life insurance reserves"; and, two, at the time amounts in the nature of interest are accrued, to determine whether these amounts are to be excluded in addition to the amounts precomputed and pre-established as life reserves. Therefore, this Court should

[17] Section 801 generally deals with the question of whether or not an insurance company is a *life* insurance company. This question, in turn, depends upon whether the "life insurance reserves" plus certain premiums comprise more than 50% of the company's total reserves.

hear this appeal before this issue spawns substantial litigation, and clarify for the life insurance industry the parameters under which payments in the nature of excess interest are attributable to policy and other contract liabilities, and therefore, excluded from a life insurance company's taxable investment income.

CONCLUSION

For the reasons stated hereinabove, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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